Economic *Context*

Overview of U.S. and California Economies

U.S. Economy and Financial Markets

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Economy Overcomes Obstacles in 2005. The economy grew faster than average in 2005 despite surging energy costs, increased inflation, rising interest rates, and three major hurricanes. U.S. real gross domestic product (GDP) increased 3.5 percent in 2005, above the ten-year average of 3.3 percent annual growth. Growth was led by fixed investment spending, which increased 8.1 percent after adjusting for inflation. Exports were also a growth leader in 2005, expanding 6.9 percent in real terms.

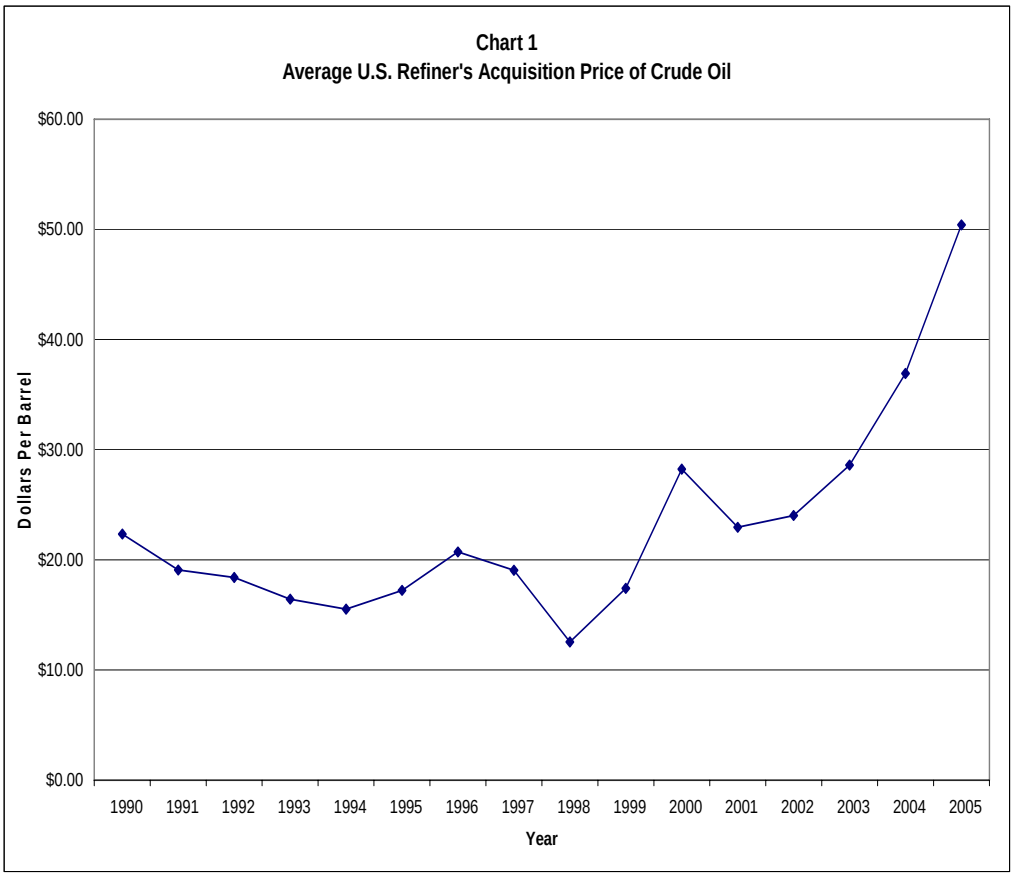
Real consumer spending rose 3.5 percent in 2005, down from 3.9 percent growth in 2004. Durable goods increased 4.5 percent, followed closely by a 4.4 percent increase in nondurable goods spending.

The weakest major sector of the U.S. economy in 2005 was government spending. Real government spending increased 1.8 percent in 2005, much less than overall GDP growth.

Soaring Energy Costs. The average annual U.S refiners' acquisition price of crude oil increased 37 percent in 2005, capping a third straight year of rising double digit increases (see Chart 1). The annual average crude oil price was $50.40 per barrel in 2005, more than double the 2002 average.

Energy Costs Boost Overall Inflation. The U.S. consumer price index rose 3.4 percent in 2005, up from 2.7 percent in 2004. Soaring energy costs were largely responsible for the higher inflation rate in 2005. Consumer prices excluding energy increased 2.2 percent in 2005.

Rising Short Term, But Flat Long Term Interest Rates. The Federal Reserve Board began increasing the target for the federal funds interest rate in late June 2004 and continued to steadily increase rates throughout 2005 and into early 2006. From January 2005 through March 2006, the federal funds rate rose from 2.25 percent to 4.75 percent, as the Federal Reserve Board increased the target rate ten times by 0.25 percent increments. These Federal Reserve



Growth in corporate earnings over the past four years has been more than twice the long-term average.

Board actions resulted in corresponding increases of a similar magnitude in most short-term interest rates (financial securities with maturities less than one year).

Despite the Federal Reserve Board actions, long-term rates remain relatively low by historical standards. The average 10-year U.S. Government Treasury bond yield was 4.3 percent in both 2004 and 2005. During the 1990s, 10-year U.S. Government Treasury bond yields averaged a much higher rate, 6.7 percent.

Corporate Earnings Strong. Strong economic growth, productivity growth, low interest rates, and increasing energy prices combined to result in rapid growth in corporate profits in recent years. U.S. corporate earnings before taxes increased 16 percent in 2005. This is the fourth consecutive year of double-digit gains. Growth in corporate earnings over the past four years has been more than twice the long-term average. Annual growth in earnings before taxes averaged 7.3 percent per year over the past ten years.

Major Stock Indices Up in 2005. Major stock market indices posted moderately strong increases in 2005. The Standard and Poor's composite stock index increased 9 percent from February 2005 to February 2006. The Nasdaq stock index increased 12 percent over the same time period.

Average Growth Outlook for 2006 and 2007. Many economic forecasters expect economic growth to slow from that of 2005, but remain close to the long-term average. A February 2006 survey of 53 professional forecasters polled by the Federal Reserve Bank of Philadelphia calls for real GDP to increase 3.2 percent in both 2006 and 2007.[1]

Available data indicate that the California economy generally mirrored the U.S. economy in 2005.

Many forecasters also expect relatively strong corporate earnings growth to continue. The forecasters surveyed by the Philadelphia Federal Reserve Bank predict corporate earnings after taxes to increase 11.0 percent in 2006 before slowing to 5.6 percent growth in 2007.

California Economy

California Parallels National Economy. Available data indicate that the California economy generally mirrored the U.S. economy in 2005. California nonagricultural employment (one of the broadest measures of economic activity available to states on a timely basis) increased 1.8 percent in 2005, a bit faster than the 1.5 percent growth in U.S. nonagricultural employment. The California unemployment rate averaged 5.4 percent, a bit above the U.S. average of 5.1 percent. Other major California economic indicators -- including personal income, wages, and consumer prices -- posted gains similar to their national counterparts.

Construction activity was particularly strong in California in 2005. A total of 208,000 residential building permits were issued in 2005, the second consecutive year in which permits exceeded 200,000 units. Permits issued in recent years have been well above the ten-year annual average of 155,000 units. The inflation-adjusted total value of nonresidential construction rose 8.9 percent in 2005.

Construction activity was particularly strong in California in 2005.

Many forecasters expect the California economy to follow the U.S. economy in continuing to perform well in 2006. According to the March 2006 issue of the *Western Blue Chip Economic Forecast* (which includes a survey of eight California economists) the average forecast calls for California nonagricultural employment to increase 1.4 percent in 2006 and 1.1 percent in 2007. These forecasters predict that California personal income will increase 5.9 percent and that taxable sales will increase 5.6 percent in 2006.

Electricity and Natural Gas Industries

Recap of 2005 Assessments. Electric, natural gas, and water companies accounted for about 60 percent of all Board-assessed values in fiscal year 2005-06. Electric generating facility companies accounted for 17 percent of the total value for these companies. The vast majority of the remaining 83

[1] "Survey of Professional Forecasters," Federal Reserve Bank of Philadelphia, February 13, 2006.

percent of assessed values for electric, natural gas, and water companies were accounted for by the large regulated utilities: Pacific Gas & Electric, Southern California Edison, Southern California Gas, and San Diego Gas and Electric.

Natural Gas

Natural gas prices are a very important component in the valuation of electric generation facilities in California. However, gas and electric distribution utilities are not materially affected because natural gas price increases are passed directly to the consumers, and not borne by the utilities. Natural gas prices have risen in recent years, and are currently relatively high by historical standards (see Chart 2). From 2000 to 2003, natural gas prices at the wellhead averaged $3.88 per thousand cubic feet (Mcf). In 2004, natural prices averaged $5.46 per Mcf, 41 percent above the average for the previous four years. In 2005, natural gas prices increased an additional 38 percent over the 2004 average, to $7.51 per Mcf. The U.S. Energy Information Administration (EIA) predicts that natural gas prices will rise slightly over the next couple of years.[2] These relatively high prices will further squeeze profit margins for many electricity generators who rely heavily on natural gas as fuel.

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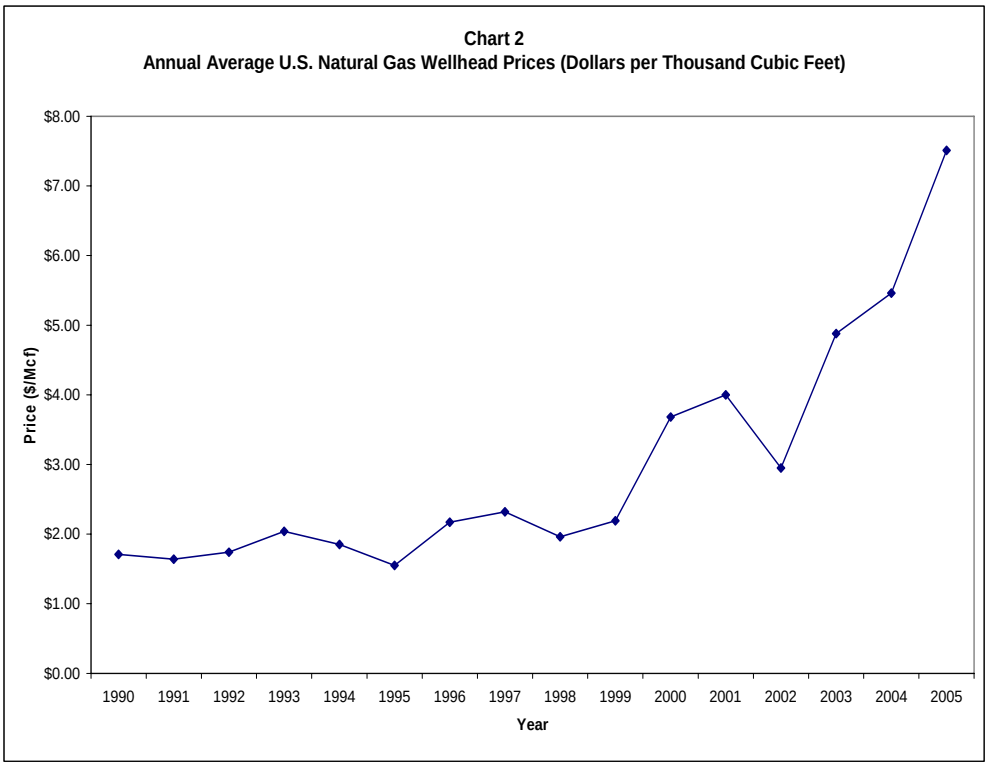

[2] "Short-Term Energy Outlook – February 2006," U.S. Department of Energy, Energy Information Administration, 2006.

Electricity

Regulatory Background and Recent Developments. Traditionally, natural gas and electricity markets were heavily regulated as "natural monopolies" through most of the twentieth century. In the late 1990s, California began using a more market-based regulatory structure. Now the transmission and distribution systems remain regulated, while the generation system is market-based for generating facilities not owned by the utilities.

While the California public utilities, which are regulated, are currently healthy, the outlook for the deregulated electric generation facilities is mixed.

Much of the current mixed regulatory system resulted from the consequences of a severe energy crisis that developed in California in 2000 and 2001. This crisis resulted in Pacific Gas & Electric's (PG&E), a major California electric utility, becoming financially insolvent in early 2001 because the company was unable to pass on dramatic increases in wholesale electricity prices charged by generators. In April 2004, PG&E emerged from bankruptcy and once again appears to be healthy financially.

While the California public utilities, which are regulated, are currently healthy, the outlook for the deregulated electric generation facilities is mixed. There is a short-run capacity surplus in California, as more than 11,000 megawatts of generating capacity have been added since 2001. More new generating facilities are under construction and are scheduled to come on-line in the next few years. As a result, many old generating facilities which are not as efficient as the new ones, are expected to be retired. Before demand can catch up with the new supply, newly constructed generating facilities may experience losses in the short-run.

Because of the new construction, the California electricity supply currently appears to be adequate, or even in surplus. The demand for California electricity peaks in the summer months, with increased usage of air conditioning equipment. While electricity supplies are likely to be adequate, they could become tight and prices could spike upward in certain locations if the summer is abnormally hot. However, with typical weather patterns, the outlook for electricity supply should be a positive one for electricity consumers.

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However the outlook is mixed for electricity generators because of the high natural gas prices. In late 2005, Calpine, a major electricity generation in California and many other states, filed for bankruptcy. Analysts cited high natural gas prices as a major problem for Calpine.

Telecommunications Industries

Recap of 2005 Assessments. Telephone and telegraph companies accounted for 35 percent of all Board-assessed values in fiscal year 2005-06. Local exchange companies had the highest valuation, followed by wireless and interexchange companies. Local exchange carriers accounted for about half

of Board-assessed values in the telephone and telegraph industries in fiscal year 2005-06. Wireless companies accounted for 32 percent of Board telecommunications assessments and interexchange companies 19 percent.

Recent Developments - Large Mergers Approved and Pending Approval. In 2005 there were two extremely large mergers of long distance providers by regional Bell operating companies (RBOCS). AT&T was purchased by SBC and MCI was purchased by Verizon. AT&T and MCI combined accounted for about 53 percent of the long distance telephone market in 2002.

Prior to their mergers, these long distance telephone service providers were facing financial difficulties amid a competitive environment and falling prices. For example, AT&T expected its revenue to decline 16 percent in 2005.[3] Both regulatory and technological industry trends have generally been running contrary to the health of long distance providers. In approving these mergers, Justice Department and Federal Communications Commission (FCC) officials cited new forms of competition as the reason those combinations would not hurt consumer and business customers.[4]

Bundled services of wireless and wireline phone service, high speed Internet service, and cable television service all provided by a single company are seen by many as a way to increase profits.

Another large telecommunications merger of wireless companies was completed in 2005. Sprint, the third largest provider of commercial mobile telephone service, combined with Nextel, the fifth largest.[5]

In March 2006 yet another very larger merger was announced. AT&T disclosed that it agreed to purchase BellSouth. This merger is the fifth largest announced merger in U.S. history.[6] If approved, AT&T would be the largest phone company in the world. In addition, the merger would reunite four of the RBOCS created in the historic 1984 breakup of AT&T. However, unlike 1984, many analysts believe that competition from other phone companies, cable companies, and Internet companies will enable this merger to be approved by the regulatory authorities.

Competition in Telecommunications. These mergers illustrate the competition and interrelationships among local and long distance wireline phone service, wireless phone service, cable service, and Internet companies. Rapid advances in technology are making these various services more similar to one another.[7] Bundled services of wireless and wireline phone service, high speed Internet service, and cable television service all provided by a single company are seen by many as a way to increase profits. However, to provide these services efficiently requires hugh investments and the ability to spread

[3] "SBC-AT&T Savings Rely on Job Cuts," *Wall Street Journal,* February 2, 2005.
[4] "Pack Represents Gamble Regulators Will Accept A New Telecom Giant," *Wall Street Journal,* March 6, 2006.
[5] Federal Communications Commission press release, August 3, 2005.
[6] "Will Verizon Try to Dial Up a Deal*?"* *Wall Street Journal,* March 6, 2006.
[7] "A Reborn AT&T To Buy BellSouth," *Wall Street Journal,* March 6, 2006.

fixed costs over large numbers of customers. According a Wall Street Journal article discussing the AT&T BellSouth merger,

> The recent history of AT&T in its many incarnations underscores an extraordinary transformation in telecommunications. Rarely has a single industry seen so many deals – and more are now expected – in response to competition and rapid technological change.

As competitive companies converge on bundled services, decisions need to be made as how many of the current fee and tax structures will be applied.

A 2005 article in *Business Economics,* the journal of the National Association for Business Economists, concludes that there is significant competition in the telecommunications industry:

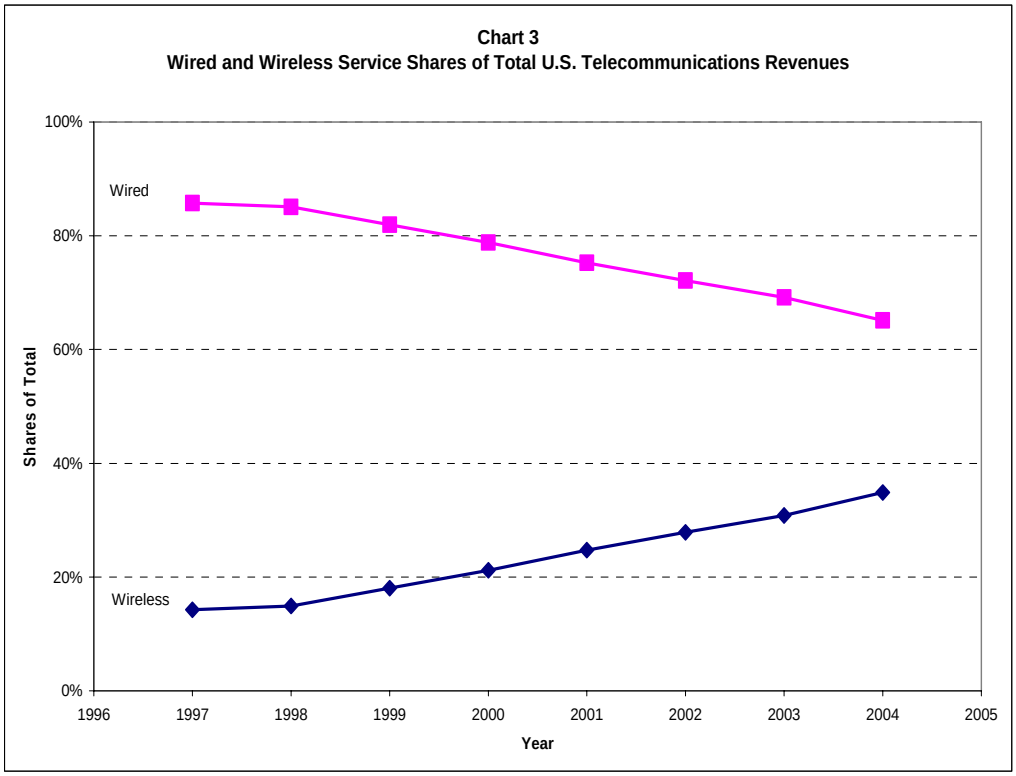
> The research presented here provides some evidence in the deregulation debate. The finding that intermodal competition is significant in the communications market and that local competition is enhanced by it suggests regulatory policies ought to account for these effects – perhaps without regard to CLEC *[competitive local exchange carrier]* line share.[8]

Regulatory Changes Ahead. One of the factors that will have a profound impact on the telecommunication competition will be government regulation. As competitive companies converge on bundled services, decisions need to be made as how many of the current fee and tax structures will be applied. Such fees and taxes include the Universal Service Fund (USF), 911 (Emergency User Surcharge), local government franchise fees and other local utility taxes and fees. Federal and state regulators as well as federal, state and local governments are currently addressing these very complex fee and tax structure issues.

According to FCC data there are now more wireless subscribers than landline subscribers.

Wireless Services Growing, Wired Services Declining. The wireless industry has grown rapidly in recent years, mostly at the expense of wired phone services. In 1997, wired services accounted for 86 percent of total U.S. telecommunications revenues and wireless services accounted for 14 percent (see Chart 3).[9] By 2004, the wired market share had dropped to 65 percent of total U.S. telecommunications revenues and the wireless share had risen to 35 percent. According to FCC data there are now more wireless subscribers than landline subscribers.[10] After peaking at $301.8 billion in 2001, total telecommunications revenues declined three straight years, and stood at $289.1 billion in 2004. This is a decline of about 4 percent over a three-year period.

[8] "Competition in Local Telecommunications," Christopher Swann and David G. Loomis, *Business Economics,* National Association for Business Economists, April 2005.
[9] *Universal Service Monitoring Report,* Federal Communications Commission, December 2005.
[10] *Taxexpress,* Federation of Tax Administrators, July 11, 2005.



… competition continues to afford many significant benefits to consumers.

Benefits to Consumers. According to the FCC's most recent *Annual Report on State of Competition in the Wireless Industry,* "Indicators of market performance show that competition continues to afford many significant benefits to consumers." In 2004, wireless subscriptions increased 15 percent, time spent talking on mobile phones increased 14 percent, and text messaging traffic more than doubled. At the same time, the cellular consumer price index declined 1.0 percent, while another measure of pricing -- revenue per minute (RPM) --- fell 12 percent.[11]

Fewer Access Lines. The number of wired access lines has decreased in recent years. Many consumers are using wireless phones in lieu of having wired telephone line. Most RBOCs have seen their numbers of access lines decrease about 5 percent in 2005.[12]

Broadband Close to Saturation. Broadband subscriptions increased rapidly over the past several years, providing a source of revenue growth for the companies offering them. The number of U.S. broadband subscribers has increased from 4.3 million in June 2000 to 32.4 million by 2004.[13] However,

[11] "FCC Adopts Annual Report on State of Competition in the Wireless Industry," press release, September 30, 2005.
[12] *Industry Trends*, "Telecommunications: Wireline" Standard and Poors, January 2006.
[13] *Broadband Deployment in California,* (draft report), February 1, 2005, California Public Utilities Commission.

according to a survey released in early 2006, broadband growth is expected to slow this year as the market is close to saturation. The survey found that 42 percent of U.S. households now have broadband access. About 64 percent of U.S. households have either broadband or narrow band Internet access.[14]

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VOIP Technology Gaining Rapid Adoption. In recent years the Internet has become the key component of the telecommunications industry. A relatively new technology, Voice Over Internet Protocol (VOIP), converts a voice telephone call into "packets," sends them over the Internet, and reconstructs the packets at the destination of the call. Compared to conventional telephone transmission technology, VOIP is relatively inexpensive. Many telecommunications companies, including wireless companies, are already using the technology. It is also possible for consumers to use VOIP directly and bypass the need for local telephone service.

Cost is only one of the many factors favoring VOIP. Growth of mobile phones, the Internet, and the rapid integration of wireless and wireline service (the so-called Fixed Mobile Convergence) are additional reasons for its growth. VOIP allows a seamless integration of wireline, wireless and Internet services.[15] The telecommunications industry would like to provide traditional and VOIP phone service, broadband service and video service to consumers in direct competition with cable providers of these services. The California Public Utilities Commission staff projects that by 2008 VOIP may account for 25 to 40 percent of total intrastate telecommunications revenues in California.[16]

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Industry Trends Summary. As discussed above, the telecommunications industry has changed radically in recent years. Today the industry consists of many interrelated services. An excellent summary of the current state of the telecommunications industry is provided below:

> The telecommunications industry is undergoing rapid change due to technological advances and deregulation. The industry that previously was identified with the telephone now includes television, radio, wireless and satellite communications, and the Internet. Cable television companies now offer phone service and Internet access, telephone companies similarly offer cable or video services along with Internet access, and the Internet has become a medium through which telephone and video services can be delivered. This technological

[14] "U.S. Households' Internet growth will be flat in 2006," *Internet Retailer*, March 7, 2006.
[15] "VOIP is the New POTS," *VON* Magazine, January 15, 2006.
[16] "PUC to Determine Extent of Regulation on VOIP Carriers," California Public Utilities Commission press release, February 11, 2004.

> convergence or blending of telecommunications, information, and computer services, together with the Telecommunications Act of 1996, has significantly changed the industry's competitive structure....[17]

Value Line estimated that railroad industry revenues rose 6.6 percent in 2005, and their staff predicted a 5 percent increase for 2006.

Furthermore, according to many industry analysts, the telecommunications industry is expected to continue to face radical changes in the years ahead. According to Duane Ackerman, chairman and chief executive officer of BellSouth, "Our industry and our business is going to change more in the next five years than it has during the last 20 combined."[18]

Railroad Transportation

Recap of 2005 Assessments. Railroad companies accounted for about 3.0 percent of all Board-assessed values in fiscal year 2005-06.

Rail Industry. After a series of mergers that took place over many years, the number of U.S. Class I railroad companies has declined to just nine.[19] Four of these companies haul 95 percent of all U.S. freight traffic. Despite this market concentration, many analysts believe that the mergers have been successful in lowering costs, achieving economies of scale, and improving efficiency.[20]

Rail to Follow Economy. Revenue and profit growth in the rail industry tend to be highly correlated with the overall economy. Therefore, revenues should continue to grow along with the economy at least through this year and the next. In late 2005 *Value Line* estimated that railroad industry revenues rose 6.6 percent in 2005, and their staff predicted a 5 percent increase for 2006.[21]

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[17] *The Taxation of Telecommunications in California in the Information Age*, James F. Prieger, Terri A. Sexton, and Annette Nellen, California Policy Research Center, University of California, Berkeley, 2003.

[18] "Phone Industry Faces Upheaval As Ways of Calling Change Fast," *Wall Street Journal,* August 25, 2004.

[19] The source of the following discussion is "Railroads; Asleep at the Switch," *Businessweek,* April 2, 2001. Class I rail companies are defined as those with revenues over $250 million and which generally operate across state lines.

[20] A study of operating efficiencies of the 1996 merger of the Union Pacific Railway Company and the Southern Pacific Transportation Company is found in "The Union Pacific/Southern Pacific Rail Merger: A Retrospective on the Merger Benefits," Dennis A. Breen, Federal Trade Commission, March 11, 2004. The study also includes discussion of the results of other studies made.

[21] "Railroad Industry," Value Line Publishing, Inc., December 9, 2005.